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You work an honest day . . .
you want an honest deal.



SAFEWAY STORES, INCORPORATED 1985 ANNUAL REPORT

## Highlights

*(dollars in thousands, except per share amounts)*

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| Sales | $19,650,542 | $19,642,201 | $18,585,217 |
| Net income | 231,300 | 185,011 | 183,303 |
| Per share | 3.83 | 3.12 | 3.26 |
| Percent of average stockholders' equity | 14.96% | 12.94% | 14.50% |
| Cash dividends per share | 1.625 | 1.525 | 1.425 |
| Stockholders' equity | 1,622,614 | 1,469,023 | 1,390,354 |
| Per share | 26.67 | 24.54 | 23.66 |
| Market price range | 26⅞-37⅝ | 21¼-29¼ | 21¼-30 |

## About the Cover

Dramatic images of real people in real jobs highlight the multimedia ad campaign we launched in 1985. Our customers "work an honest day" for the money they spend in our stores, and we work hard to keep our promise that at Safeway they will "get an honest deal."

## Contents


Message to Stockholders 1
Operations 3
Five-Year Summary 16
Financial Review 17
Financial Statements 18
Notes to Financial Statements 23
Directors and Officers 32

Fiscal 1985 was a year of significant achievement for Safeway. We completed our sixth decade of service, restructured a major overseas operation, disposed of unprofitable divisions in two other areas outside the U.S., and launched an extensive program to regain sales momentum in key domestic and Canadian markets. In the process—and for the fourth consecutive year—we turned in record earnings and raised the quarterly dividend.

## Review of Operating Results

Consolidated net income rose 25.0 percent to $231.3 million, or $3.83 per share. This includes a net after-tax gain of $34.8 million ($0.58 per share) on the sale of selected foreign operations. Excluding this one-time gain, net income came to $196.5 million or $3.25 per share, still up 6.2 percent from 1984.

Sales remained essentially flat at $19.65 billion, reflecting several factors. Chief among these were a substantial reduction in our store count, explained below; a much lower rate of food price inflation; a prolonged labor dispute in Southern California late in the year (subsequently settled); and continued declines in foreign currencies. The recent resurgence of these currencies should have a positive effect on future international sales results.

As noted in the third-quarter report, we sold our Australian operating subsidiaries to Woolworths Limited in return for a 20 percent equity interest in the combined operation. With two seats on Woolworths' board of directors, and as frequent contributors of management and technical expertise, we are maintaining an active presence in what is now Australia's largest food retailer. We expect to accrue substantial benefits from this investment.

During the fourth quarter the sale of our 36-store Germany Division was finalized. The small size and limited geographic coverage of this operation had severely restricted its growth potential. As had been the case with the previously announced closure of our Toronto Division, sale of the West German subsidiary had a minimal effect on reported results.

Asset productivity has been a top management priority at Safeway. Throughout the company there has been an increased emphasis on closing unprofitable or marginal operations. In addition to the stores disposed of in the Australian transaction and the sales of our Toronto and Germany Divisions, we closed 125 other stores last year. We are continuing to evaluate all functional areas with an eye toward redeploying assets tied up in underperforming operations into investments with greater potential returns.

Application of the LIFO method of valuing certain inventories resulted in a credit to after-tax earnings of $2.8 million in 1985, compared to a charge of $14.7 million in 1984.

## Regaining Sales Momentum

Maintaining sales growth in the face of continued low inflation, modest population gains and intense competition has proven difficult. Doing it with substantially fewer stores will be harder still. In recent months we have taken a number of steps to regain our sales momentum under these constraints. In addition to launching a major advertising campaign throughout our U.S. operating areas, we have been:

*Peter A. Magowan* *James A. Rowland*

- adding in-store specialty departments at an accelerated pace;
- merchandising our stores more skillfully to reflect local consumer needs and interests;
- making a concerted effort to insure that we remain price competitive on a market-by-market basis;
- achieving further improvements in the quality and selection of our merchandise, especially perishables;
- resetting our stores with new shelf management programs designed to eliminate out-of-stocks;

- installing the very latest in checkout systems to speed up the process; and
- promoting a new incentive program for store managers and employees to reward sales-driven performance.

Though costly in the short run, we believe these activities will yield real sales gains—and higher profits—in the months and years ahead.

## Facilities and Equipment

While we have placed increased emphasis on closing unprofitable operations, our ambitious new store program continues to move ahead. During fiscal 1985 we opened 100 new stores in the U.S., Canada and U.K., and extensively remodeled many others. Excluding the aforementioned store dispositions in Australia, Toronto and Germany, net additions to total store area amounted to almost 1.7 million square feet, a 2.27 percent gain. New store openings in 1986 are projected to number 90.

In support of these stores, we began construction on an addition to a milk plant and started work on major expansions of two ice cream plants, a frozen food warehouse and a miscellaneous perishables depot.

We continue to make substantial investments in advanced technology. As of year-end 1985, we had installed almost 400 in-store microprocessors to record employee time and attendance, track pharmacy records and prescriptions, and help account for direct store deliveries by vendors. To monitor and control energy use, 1,270 stores are currently equipped with computer-assisted power management systems; another 160 systems should be in place this year.

## New Director and Officers

At its February 1986 meeting, the Board of Directors elected a new member, John Sculley. Mr. Sculley is chairman, president and chief executive officer of Apple Computer, Inc. Prior to joining Apple in 1983, he had served for five years as president and chief executive officer of the Pepsi-Cola Company. With his superb background in marketing and general management, he is a valuable addition to the board. We look forward to his active participation.

A number of senior management changes occurred in 1985. John H. Prinster, an executive officer and senior vice president-marketing, retired at year's end following 22 years of exemplary service. A dedicated, thoroughly professional merchant, he was universally acknowledged as one of our industry's most able statesmen.

Several other key executives also left after long and distinguished careers: retail division managers Carey A. Ford (38 years), Norman D. Fingler (26 years) and Robert F. Hendy (32 years); as well as supply division managers J. L. Alm (38 years) and Roland Frederick (37 years). In related developments, executive officer and group vice president Donald J. Smith was named director of marketing; William D. Lowe was designated an executive officer and a group vice president; Donald B. Pennington, George D. Unti and John Whyte were promoted to retail division managers; and James T. Summers was appointed manager of our Grocery Manufacturing Division. Others elected as officers were service division managers L. F. Ludwig, John W. Mench, William L. Morgan and Ronald K. Parmelee.

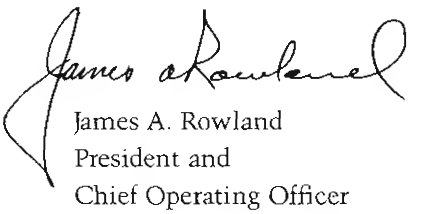
On a sad note, we mourned the death last December of Robert A. Magowan, former chairman, president and chief executive officer. The value of his contributions to this company, and the entire food industry, were significant. (See tribute, inside back cover.)

## Outlook

For 60 years Safeway has provided millions of shoppers with quality, service and value. To the extent that we can satisfy ever-changing consumer demands for more services, greater convenience and better products, our seventh decade holds promise of continued success.

As for 1986, a 53-week fiscal year, we look for gratifying results on the strength of a generally favorable economy, an aggressive store expansion and modernization program, and a thoroughly sales-driven orientation at every level of the organization.

Peter A. Magowan
Chairman of the Board and
Chief Executive Officer



James A. Rowland
President and
Chief Operating Officer

# YOU WORK AN HONEST DAY... YOU WANT AN HONEST DEAL

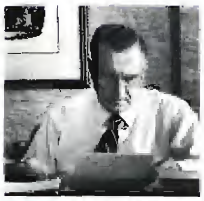
In October 1985, Safeway launched a multimedia ad campaign that has already received favorable reviews from the industry and our customers alike. More than 20 separate TV commercials target distinct demographic groups, representing specific segments of our customer base. Under the direction of Joseph Hanwright, noted for his ability to capture "real" people on film, the ads highlight authentic scenes of Americans at work.

The message is clear: "You work an honest day...you get an honest deal" at Safeway. That slogan is repeated and supported in national magazines, local newspapers and on radio stations throughout our U.S. operating areas. We want our customers to know that we appreciate how hard they work.

But we at Safeway work hard, too.

The bountiful produce sections, the enticing upscale displays in our specialty departments and the profusion of products on our shelves do not just happen. More than 164,000 employees work *their* honest days to put them there, to make sure that every customer who passes through a Safeway checkstand receives good value in a fair exchange for hard-earned dollars.

In the following pages we offer a glimpse into the honest days of five key Safeway executives. They work behind the scenes, unnoticed by our customers. But the fruits of their labor become clearly visible where it really matters—in our stores, on our shelves, and in the communities we serve.



6:45 am: Review marketing plan

9:50 am: Meet w/ mdsg. managers

1:15 pm: Preview TV ads

3:30 pm: Visit new deli

6:00 pm: Leave for Little Rock

*Group vice president Don Smith was named in 1985 to succeed John Prinster as director of marketing. Smith brings 36 years of retail experience to the post, and a commitment to continue the results-oriented programs initiated by his predecessor.*

*Over the past few years, Safeway has been experimenting with several bold, innovative marketing concepts. These ideas have now been thoroughly tested and proven. Smith's sensitivity to retail needs will help assure their smooth implementation over a broad geographic base.*

*"I am convinced that Safeway has the most dynamic long-range marketing plan in the industry," Smith says. "My job now is to forge a closer bond between marketing and retail—to integrate that plan, not just into our stores, but into the lives of our managers and employees at all levels of our retail operations."*

*Having worked his way up through the ranks, including five years as manager of one of our most successful retail divisions, Smith is well suited to the task. "I think I can anticipate—and therefore more easily avoid or solve—problems that our marketing efforts may create in the stores," Smith claims. "I have been there, and the people who must make our ideas and strategies work know that. I believe that fact will work to our favor."*

*According to Smith, Safeway is in the midst of a transition from an "operations" driven company to a "market" driven one. The cornerstone of that philosophy is the customer, and rapidly changing consumer needs and demands. The key, he says, is to isolate long-term trends and separate them from the fads.*

*Toward that end, Smith and his staff initiate and analyze countless consumer surveys and studies, anticipating and responding to often-subtle shifts in the preferences, demographics and lifestyles of our customer base. The result is a finely-tuned marketing team, driven by the challenge of pleasing a diverse and demanding public.*

Safeway's "honest day, honest deal" advertising campaign depicts our customers' work and lifestyles. The ads highlight the cornerstone of our marketing strategy: fulfilling the diverse needs of millions of individuals who visit our stores.

Departing from past formulas, our new commercials narrowly target specific consumer groups, including working women, Mexican-Americans, senior citizens, rural residents, blue and white collar workers. They portray upscale shoppers, students, young professionals, apartment dwellers and singles. The task of satisfying this eclectic customer base requires responsive and imaginative methods and programs.

In 1985 we accelerated our response to the increasing demand for one-stop shopping by installing 2,170 new specialty departments. In 1986 plans call for major additional commitments in full-service seafood counters, delicatessens, bakeries, natural food centers, salad bars and even soup bars.

With 713 service floral departments in place at year's end, we remain the largest retailer of plants and flowers in the world. Our 479 in-store pharmacies rank us second among

*In-store delis offer convenience for time-conscious shoppers, and provide us with additional merchandising opportunities.*

supermarket retailers of prescription and over-the-counter drugs. In 1986 we intend to add floral departments to 175 stores and install 155 more pharmacies.

Just a decade ago, the typical Safeway store stocked some 65 varieties of fresh fruits, vegetables and herbs. By responding to ethnic tastes, and establishing sources of supply for off-season and exotic items to attract upscale shoppers, we are now able to offer our produce managers a choice of more than 400 fresh items with which to stock their departments. Lemon long grass, lychees, antimoya, Japanese pears, sugar apples—our customers request scores of items we had never heard of in years past. Many, such as jicama, kiwi and sharlyn melon, have become supermarket standards. Safeway buyers have learned to anticipate and satisfy these new demands.

We strengthened several programs in 1985 to promote the superior quality and variety of Safeway produce. Our *Fresh and Full at Five* campaign caters to two-income families by

*The produce department, most often cited by customers as the reason they choose a supermarket, remains the centerpiece of our stores. Our orchard bin format reflects the farm-fresh quality of our fruits and vegetables, while our Fresh and Full at Five program assures abundance and variety for increasing numbers of twilight shoppers. Only 10 years ago, our typical produce department stocked some 65 items. Today, a store may carry as many as 400.*

*Full-service seafood departments are fast becoming a Safeway hallmark. Their universal popularity reflects changing consumer lifestyles and a growing demand for fresh, natural foods.*

assuring abundant selection and enticing presentation during the early evening shopping hours they prefer. In many stores we display fruits and vegetables in wooden orchard bins, creating a farm-fresh look. By isolating the department with overhead awnings, we encourage shoppers to linger in a subdued environment, while track lighting draws their attention to the products.

*Salad bars attract busy singles who might otherwise bypass the supermarket.*

In surveys, consumers consistently cite produce as the most important single factor they consider when deciding where to shop. Our experience confirms that the produce department's share of total store sales will increase wherever we install orchard bins and other new marketing techniques. In attracting new customers by highlighting the superior quality and variety of our fruits and vegetables, we hope to win their loyalty by offering them convenience, service and value throughout the store.

Responding to changing customer lifestyles, we have also modified our meat marketing strategies. Two-career families, with little time to cook, have stimulated sales of sliced chicken and meats for fast, nutritious oriental dishes. We have added more kitchen-ready cuts, such as stuffed pork chops, meat loaf, kabobs and many others. We also offer fresh squab, pheasant and other items once available only in gourmet or specialty markets.

Although traditional cuts of beef are not as popular as they once were, we promote the nutritional value of red meats in our newspaper ads and with posters and informational materials in our stores. Our support of National Meat Month, for example, led to increased meat sales during January 1985.

Behind the scenes at Safeway, technology plays a major marketing role. Out-of-stock merchandise is a frequent source of consumer dissatisfaction throughout the supermarket industry, and a key factor in shifting customer loyalties. We are attacking the problem with our Shelf Allocation Management (SAM) software, which predicts the quantity of each item a store will need to meet demand between deliveries. SAM also devises shelf plans to match customer purchasing habits in individual stores, and interfaces with our Direct Product Profitability program to insure optimal shelf placement for better-selling products. Continued use of SAM will improve system accuracy by increasing the volume of data derived from actual product performance.

We are using other computer applications to monitor product profitability and improve purchasing. The Safeway Pricing System measures the effect of price changes on gross profit, while Promotion Allowance Control tracks supplier discounts, allowing us to take full advantage of them.

Just as our customer obligations do not end with product quality, variety and value, our commitment to stockholders is not limited to the efficiency of backstage technology. The supermarket industry remains a "people" business, and the value of person-to-person communication—both at point of sale and behind the scenes—is becoming even more critical in an increasingly impersonal and fast-paced world.

In our stores, we have improved service by hiring more courtesy clerks and restructuring employee orientation programs. Before we assign trainees to positions involving public contact, we thoroughly indoctrinate them in the importance of placing the customer's needs above other priorities.

Backstage, we have improved people-to-people communication between our corporate marketing staff and retail management. This allows us to be more responsive to local

*The success of our in-store floral departments underscores consumer preference for one-stop shopping.*

competitive situations, and better prepared to tailor marketing strategies to the diverse demographics of the more than 2,300 communities and neighborhoods we serve.

Our marketing success hinges on our ability to gauge changing needs and respond to them quickly and efficiently. By meeting and satisfying shoppers on all fronts—from friendly employees and wide product selection to competitive service and quality—we will live up to our advertised promise of an honest deal.

6:45 am: Check WSJ crop news

10:00 am: Drive to Walnut Creek office

1:00 pm: Review futures activity

3:20 pm: Taste new ice cream line

5:10 pm: Visit port facility

*To E. N. Henney, executive vice president of Safeway's supply operations, balance is the key to success.*

*In our stores, the delicate balance between national brands and products that carry the Safeway label has a profound effect on the bottom line. Too many house brands decrease store traffic and sales by turning away customers attracted by national advertising. Too few depress gross profit levels and limit shoppers' savings opportunities.*

*With the 21 product groups of our* Ribbon S *line, Safeway strives to match the quality of the best national brands at an attractive price. Our label on nine other brands assures customers of dependable products at discount prices, without the wide fluctuation in quality found in many so-called "generic" products.*

*Specialists on Henney's staff monitor each member of the Safeway brands family of products for quality and sales performance. It is a dynamic process of continually adding new items as changing markets present new opportunities, while discontinuing old ones that have outlived their profit potential. In 1985 the number of products bearing Safeway labels remained about the same as in 1984, but approximately 100 new items were added while a similar number was dropped.*

*By keeping a corporate finger on the pulse of commodity markets and other sources of supply; by continually developing more efficient production methods and appropriate product-quality standards; and by carefully analyzing the advantages of purchasing versus manufacturing, Henney's organization contributes significantly to the overall profitability of the company.*

When properly integrated into our store stocking plans, along with national brands, Safeway's own products generate above-average profits. Our private label program includes some 30 brand names, representing more than 4,000 items. A typical store will stock 2,100 of these products, accounting for a significant portion of total sales.

As a retailer, we are not in the expensive business of basic research and new product development. Rather, our supply operations strategy hinges on developing new ideas for more efficient processing and marketing of existing products. With 87 manufacturing and processing plants in the U.S. and Canada, and 6,358 employees, supply operations represent a major commitment of company resources.

*Highly trained technicians at our modern lab in Walnut Creek, California assure the quality and nutritional value of Safeway's bakery products.*

We enhance return on that investment by carefully managing those resources to take full advantage of emerging technology. Our Direct Product Profitability program compares performance of Safeway brands with national brands. It aids us in making informed predictions of which products are likely to succeed under the Safeway label.

Supply operations managers are constantly examining and redeploying the resources at their disposal with an eye toward greater efficiency and changing markets. By consolidating our Stockton, California specialty meats and sausage plants into a single facility in 1985, we reduced processing costs for both products. In Canada, we redesigned our conventional cannery in Taber, Alberta to package fruit juices in the more popular aseptic fiber containers. Careful analysis of product performance led to a line of salt-free breads and canned fruits, which are gaining popularity among an increasingly health-conscious customer base.

While supply's primary mission is to provide our own stores with quality products at attractive prices, we are taking advantage of other markets as well. We have removed all Safeway identification from the 774 products of our Glencourt line, for example, so we can market them to military commissaries, other retailers, wholesalers and manufacturers. Outside sales, including sizable exports to new Pacific Rim markets, were up significantly in 1985.

*Exhaustive cost/benefit analyses of making versus buying a product precede any decision to build a Safeway manufacturing plant. This highly automated processed cheese line at our LaCrosse, Wisconsin plant is generally recognized as among the best run such facilities in the country. While its main function is to supply our own stores with highest quality products, the plant generates additional income by packaging under other labels as well.*

6:20 am: Inspect loading dock

9:00 am: Refine new whse. layout

11:00 am: Visit dist. center

1:30 pm: Meet w/ regional task force

5:15 pm: OK whse. layout changes

*It was still early in the century when Safeway founder M.B. Skaggs coined the motto, "distribution without waste." Bill Albers, who was named to the company's top distribution post in 1984, has reaffirmed our commitment to that ideal.*

*"The key," says Albers, "is to get all of our retail divisions working toward the same goal." That is easily stated, but more difficult to achieve, in a decentralized company that delegates operating authority to division management.*

*Plans and programs emanating from corporate headquarters must offer division operators the advantages of standardization, with enough flexibility to solve local problems. According to Albers, this can happen only through close communication and teamwork.*

*Toward that end, Albers has established several regional task forces to study methods and programs from one area, with an eye toward application in others. The prevailing philosophy is, "If it's working, don't fix it. If it's not, look around and see what others are doing."*

*This approach has led, not only to many warehouse and transportation innovations, but to a new view of automation.*

*"A few years ago automated warehouses appeared to be the wave of the future," Albers recalls, "but the rosy glow has faded from much of that technology."*

*Fully automated warehouses are appropriate where scarce adjacent property prevents us from expanding existing facilities to meet growing distribution needs, but modern conventional methods are still more cost-effective in most of our operating areas.*

No function in the company is better positioned to take advantage of Safeway's economies of scale than distribution. Pennies saved on the highways and in our warehouses translate into millions of dollars when multiplied by the billions of pounds of products we handle, and the millions of miles we move them each year. Our distribution cost as a percentage of sales continued to decline in 1985, due in large part to new product-handling technology and better management of existing resources.

We reduced the number of trucks we operate *and* the miles they traveled, but increased total tonnage transported. New fuel-efficient equipment operates at a substantially lower cost per mile than conventional tractor-trailer rigs, and allows us to carry bigger payloads. As we begin to enjoy the long-range benefits of the low maintenance and extended life of this equipment, savings will increase. In 1986, we will make even greater use of energy-saving transportation technology.

While our own trucking fleet is the mainstay of the Safeway distribution system, we also use for-hire services when it is more economical to do so. Last year we moved more than five billion pounds by outside trucking firms, steamships, rail cars and aircraft to augment our internal transportation operations.

In our warehouses, we reduced administrative costs by streamlining management structures, and improved product-

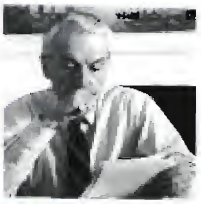
*Modern equipment, such as this double-reach lift truck and double-load pallet jack, significantly increase the efficiency of workers in our distribution centers.*

handling efficiency by processing larger orders. Coupled with more flexible union contracts and fewer labor disputes, these measures led to an overall 6 percent increase in warehouse productivity in 1985.

We further improved distribution efficiency by: reducing pallet costs, making more backhauls, lowering tire costs through a new national account program, making better use of our labor force, installing on-board computers to monitor vehicle performance, and increasing average load size.

Also in 1985, we established Oakland Property Brokerage, a subsidiary which arranges transportation with common carriers for other companies.

*Initial tests of "Class 7" tractor-trailer rigs have yielded substantial savings in fuel and maintenance costs. If subsequent trials support these preliminary findings, we will greatly expand our use of this state-of-the-art equipment. This is only one facet of a comprehensive effort to streamline our distribution system.*



*8:00 am: Review Far East venture*

*11:30 am: Discuss Casa Ley results*

*1:00 pm: OK new U.K. store plans*

*3:30 pm: Confirm Caribbean proposal*

*6:20 pm: Depart for Cairo*

*John Kimball's job sounds simple enough: "We try to run the existing operations profitably, while always looking for new opportunities to grow." But, as the group vice president responsible for Safeway's retail operations outside the U.S. and Canada, his task often takes on shadings of diplomacy, politics, demographics, cultural sensitivity, international law and world economics. There are few formulas or precedents. Each country is different, each partnership unique, each store site one-of-a-kind.*

*"There is a thin line between what you can transfer from our North American operations and what you can't," says Kimball. "On the one hand, you must overcome the natural tendency of a different culture to say, 'nothing that works in California is going to work here,' while, on the other hand, you must resist the temptation to superimpose everything that works here on an entirely different situation."*

*As with any healthy cross-cultural trade arrangement, foreign operations in food retailing are a two-way street. "It is not enough simply to provide another country with the benefit of our operational expertise," says Kimball. "We must also be open to new ideas from outside the U.S. that we can apply to our operations here."*

*That philosophy has led to design changes in some U.S. labels, signs and in-store displays based on successes in the U.K.*

*Also from Britain, we have imported the idea of "kitchen-ready" products such as fresh meats, poultry, fish and vegetables already trimmed and displayed, ready for cooking.*

*Likewise, our experience in Mexico has enhanced our merchandising efforts in Mexican-American population centers in the U.S.*

*Nor are the benefits limited to in-store applications. Reciprocal purchasing agreements between our buyers in different countries are beginning to yield impressive results. By having our European wine buyers in the U.K. purchase for the U.S. market, for example, we take advantage of their expertise and long-standing contacts, while they enjoy the advantages of increased economies of scale.*

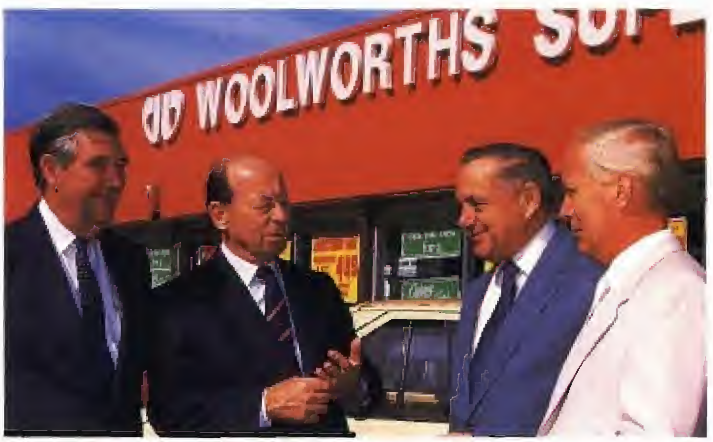
After 22 years of successful independent operation down under, Safeway in 1985 restructured its Australian operating subsidiaries, consolidating with retailer Woolworths Limited (unrelated to the U.S. firm, F.W. Woolworth Co.) By selling these assets to Woolworths, we acquired a 20 percent equity interest in a combined operation that is now the largest food retailer in the country.

We believe the consolidation will benefit shareholders and customers of both companies by improving economies of scale in purchasing, opening access to a greater market area, allowing more efficient use of facilities and equipment, creating a good mix of managerial experience, and permitting joint development of new systems. Further, we expect our share of earnings from Woolworths to compare favorably with past earnings from our own operations.

Our U.K. operations continued to perform well through 1985, exceeding slightly our ambitious profit plan for the year. At fiscal year's end we operated 121 supermarkets there, with the trend moving toward larger stores in the 35,000 to 40,000 sq. ft. range. We expect to open 12 to 14 new outlets per year in the U.K. for the foreseeable future.

In spite of unfavorable economic conditions in the nation as a whole, our venture with *Casa Ley* in Mexico continues to be mutually profitable. Performance there outpaced the high rate of inflation in that country, and two more large stores are in the pipeline for 1986.

In keeping with our stated strategy of redeploying the assets of underperforming operations, we sold our 36-store Germany Division late in 1985.



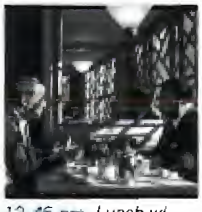

*Left to right: J.W.R. Pratt, Executive Director, and Sir Eric McClintock, Chairman of Woolworths Ltd.; Safeway President James A. Rowland, and A.J. Harding, Woolworths' Managing Director and CEO.*

Elsewhere in the world, we continue our aggressive exploration of undeveloped markets. Basically, we take a four-pronged approach to foreign diversification opportunities. Occasionally, we consider operations that we would own and operate ourselves but, more often, will look for a local entrepreneur. Sometimes we will enter a market as an investor in an existing operation or, as with our successful Middle East ventures, simply contract to provide managerial and operational expertise.

*Safeway has become a household word in the United Kingdom, and the exceptional performance of our 121 stores there has prompted an aggressive expansion program. Current plans call for 12 to 14 new store openings per year.*

9:00 am: Visit USDA

11:30 am: Meet Jack Anderson



12:45 pm: Lunch w/ Bob Kemp

3:30 pm: Discuss tax bill w/ Sen. Dole

6:40 pm: Polish Va. Retail Assn. speech

*To function effectively within razor-thin net profit margins, line managers in the retail food industry must continually fine-tune their operations to assure maximum benefit from limited resources. Much the same problem faces Robert E. Bradford, Safeway's senior vice president, public affairs.*

*Says Bradford: "The first task is to assess your resources. Then, when you know where you're strong—and where you're not—build programs that will bring the maximum positive exposure at the least cost in the areas where they will do the most good."*

*Obviously, with only 1 percent net profit, Safeway cannot afford lavish programs that bring worldwide exposure to some other industries.*

*"But that's okay," Bradford contends. "We don't serve the world. We serve individual communities. There we have an abundant resource in the form of our employees—people who live in those communities, who work in them, and who for years have been selflessly serving them both on and off the job."*

*Based on that philosophy, Bradford reorchestrated Safeway's community relations programs in 1985, directing scarce financial resources into the communities to encourage and reward employees for individual volunteer efforts.*

*Under our new Community Pride program, for example, a committee of peers in each retail division decides on requests for grants from employees to organizations in which they have been actively involved for at least six months. If approved, Safeway issues a check, which the employee personally delivers to the organization.*

*"It's a win-win program," claims Bradford. "The organization increases its revenue, which improves the quality of life in the community. The employee receives well-deserved recognition from peers and colleagues, and Safeway benefits from goodwill in the press and the community."*

*Eventually, Bradford claims, that goodwill translates into increased sales, "and that is, after all, the purpose behind the program."*

Safeway's 1985 was a banner year for public affairs, highlighted by the presentation of the President's Private Sector Initiative Citation for outstanding public service. Safeway was lauded for its participation in missing children programs, food banks, the Young Astronaut Program and other initiatives.

Even public affairs efforts we coordinate from headquarters are focused on the community. The $2 million worth of wholesome but commercially unusable products we dontated to food banks and other organizations last year helped feed the needy in towns and cities we serve. A drive

*Presentation of the President's Private Sector Initiative Citation for exceptional community service highlighted a banner year in public affairs. President James A. Rowland accepted the honor on behalf of some 164,000 fellow employees at a Rose Garden ceremony in June.*

we began in 1985 produced a donation of $1,405,269 to Easter Seals in March 1986. The entire amount grew from employee projects.

On the government relations front, we formed our own political action committee. First year results exceeded goals for both funding and participation. In California, Safeway helped frame innovative recycling legislation, which satisfies both industry and environmental needs. In states that have not yet followed the lead of federal lawmakers, we continue to support truck deregulation.

The increasing cost of liability awards is fast approaching crisis proportions for American business. We are working with the California legislature, other affected industries and the U.S. Chamber of Commerce for repeal of the so-called "deep pockets" law, which assesses liability based on ability to pay rather than actual fault. In 1986 we will intensify efforts to alert the public to the dangers of irresponsible and unlimited litigation, and continue to urge general tort reform.

In keeping with the trend toward decentralized government, Safeway's legislative relations thrust will move more toward state, county and city levels in 1986. We will maintain our strong presence in Washington, D.C., but the local approach will give us a more audible voice in the issues that affect us most directly in our operating areas.

*This Young Astronaut chapter, sponsored by Safeway employees in Austin, Texas and photographed at the Lyndon B. Johnson Space Center in Houston on January 11, 1986, reflects our commitment to the program's goal of stimulating interest in math and science among America's youth. While we were stunned by the tragedy that befell the crew of the space shuttle Challenger on January 27, we have redoubled our commitment to this worthwhile objective.*

## Five-year Summary

*(Dollars in thousands, except per share amounts)*

| | 1985 | 1984 | 1983 | 1982 | 1981 |
|---|---|---|---|---|---|
| **Operations** | | | | | |
| Sales | $19,650,542 | $19,642,201 | $18,585,217 | $17,632,821 | $16,580,318 |
| Percentage annual increase | 0.04% | 5.69% | 5.40% | 6.35% | 9.78% |
| Cost of sales | 14,872,247 | 15,004,547 | 14,249,843 | 13,628,052 | 12,945,923 |
| Gross profit | 4,778,295 | 4,637,654 | 4,335,374 | 4,004,769 | 3,634,395 |
| Percent of sales | 24.3% | 23.6% | 23.3% | 22.7% | 21.9% |
| Operating and administrative expenses | 4,350,635 | 4,214,443 | 3,920,736 | 3,653,561 | 3,363,478 |
| Percent of sales | 22.1% | 21.5% | 21.1% | 20.7% | 20.3% |
| Operating profit | 427,660 | 423,211 | 414,638 | 351,208 | 270,917 |
| Interest expense | (172,906) | (151,263) | (134,270) | (129,484) | (120,393) |
| Gain on sale of foreign operations | 49,046 | | | | |
| Other income, net | 49,816 | 26,874 | 20,565 | 26,536 | 15,822 |
| Income taxes | (122,316) | (113,811) | (117,630) | (88,600) | (58,062) |
| Net income | $ 231,300 | $ 185,011 | $ 183,303 | $ 159,660 | $ 108,284 |
| Percent of sales | 1.18% | 0.94% | 0.99% | 0.91% | 0.65% |
| Percent of average stockholders' equity | 14.96% | 12.94% | 14.50% | 14.43% | 10.16% |
| Per share | $ 3.83 | $ 3.12 | $ 3.26 | $ 3.06 | $ 2.07 |
| Cash dividends per share | $ 1.625 | $ 1.525 | $ 1.425 | $ 1.325 | $ 1.300 |
| Average shares of common stock outstanding | 60,360 | 59,227 | 56,163 | 52,261 | 52,232 |
| **Financial Statistics** | | | | | |
| Working capital | $ 301,780 | $ 325,432 | $ 230,857 | $ 318,124 | $ 112,919 |
| Current assets per dollar of current liabilities | 1.17 | 1.21 | 1.15 | 1.16 | 1.08 |
| Additions to property | 621,758 | 701,678 | 541,238 | 511,917 | 518,330 |
| Depreciation and amortization | 333,398 | 295,290 | 264,553 | 242,371 | 226,001 |
| Total assets | 4,840,611 | 4,537,229 | 4,174,363 | 3,898,633 | 3,652,315 |
| Long-term debt | 1,315,021 | 1,392,710 | 1,187,669 | 1,256,186 | 1,137,616 |
| Equity of common stockholders | 1,622,614 | 1,469,023 | 1,390,354 | 1,137,095 | 1,075,098 |
| Per share | 26.67 | 24.54 | 23.66 | 21.74 | 20.59 |
| Cash dividends on common stock | 98,135 | 90,371 | 80,961 | 69,228 | 67,980 |
| **Other Statistics** | | | | | |
| Employees at year-end | 164,385 | 168,590 | 162,088 | 156,478 | 157,411 |
| Stores opened during the year | 114 | 195 | 145 | 153 | 159 |
| Stores closed/sold during the year | 320 | 131 | 92 | 176 | 98 |
| Total stores at year-end | 2,365 | 2,571 | 2,507 | 2,454 | 2,477 |
| Total store area at year-end (thousands sq. ft.) | 70,292 | 73,284 | 69,818 | 66,816 | 65,483 |
| Average annual sales per store | $ 7,687 | $ 7,531 | $ 7,395 | $ 7,184 | $ 6,682 |
| Price range, New York Stock Exchange | $ 26⅞-37⅝ | $ 21¼-29¼ | $ 21¼-30 | $ 13⅛-25⅝ | $ 12⅛-18⅝ |

## Results of Operations

Consolidated sales of $19.65 billion for 1985 were essentially even with 1984 sales of $19.64 billion, which were 5.7% above 1983 sales of $18.59 billion. The sales reflect lower food price inflation, lower foreign exchange rates and the sale of selected foreign operations. During 1985, the company sold its operations in Australia, West Germany and Toronto. These operations accounted for 2.5% of the company's sales in 1984. Sales in ongoing operations increased 1.7% over those in 1984.

Gross profit as a percentage of sales continued to increase. Changes in product mix, improved purchasing practices and continued distribution cost control initiatives more than offset a slight reduction in sales prices. Gross profit was 24.9% in 1985, 24.6% in 1984 and 24.5% in 1983. Application of the LIFO method of valuing inventories resulted in a provision (credit) of $(6.1) million in 1985, $2.5 million in 1984 and $(6.1) million in 1983.

Operating and administrative expenses, including depreciation and amortization, increased 6.2% in 1985 over 1984 and 6.1% in 1984 over 1983. As a percentage of sales, operating and administrative expenses increased to 22.3% in 1985 from 21.5% in 1984 and 21.1% in 1983.

Interest expense increased to $171.7 million in 1985 from $157.1 million in 1984 and $144.9 million in 1983. The 9.3% increase from 1984 to 1985 resulted primarily from the company's shift from lower-cost secondary financing to the more expensive public market.

A gain of $48.1 million ($.82 a share) was recorded on the sale of foreign operations. On the sale of Australian operations, the company acquired 49% interest in Australian-based retailer Woolworths Limited. These assets are part of the company's investment program in these select countries. Income taxes on the sale of foreign operations could be offset against the company's tax loss carryforwards.

Other income for 1985 was $60.5 million as compared to $41.0 and $20.0 million in 1984 and 1983, respectively. The increase was attributed primarily to gains on the disposal of closed facilities, foreign currency transactions and to the effect of new investments.

The provision for income taxes decreased to 44.8% of pretax income from 46.1% in 1984 and 49.1% in 1983. The decrease in 1985 was mainly due to taxation of the gain on the sale of the foreign operations at capital gains tax rates rather than ordinary tax rates.

Net income increased 2.9% in 1985 to $207.1 million from $201.3 million in 1984 and $184.5 million in 1983. Excluding the gain on the sale of foreign operations, 1985 net income increased 6.2% to $196.5 million, due primarily to improved operations in the U.S.

See Note L for further information on the effects of inflation and changing prices on operating results.

## Liquidity

Consolidated working capital decreased $23.6 million to $301.8 million in 1985 from $325.4 million in 1984, compared with $230.9 million in 1983. The current ratio also decreased to 1.17 from 1.21 and 1.15 in those years. Had the company valued its inventories using the FIFO method, its current ratio would have been 1.36, 1.42 and 1.35, and working capital would have been $394.5, $644.7 and $519.9 million at year ends 1985, 1984 and 1983, respectively.

The increase in short-term investments resulted principally from cash received on the sale of the operations in West Germany and Toronto, and reinvestment of short-term borrowings at rates in excess of the cost of borrowings.

Average commercial paper and bank borrowings were $158.5 million in 1985 compared to $159.6 million in 1984 and $164.5 million in 1983. The average interest rates paid on consolidated short-term borrowings were 8.8%, 10.0% and 9.9% in 1985, 1984 and 1983, respectively.

## Capital Resources

Capital expenditures were $621.8 million in 1985, compared with $701.7 and $541.2 million in 1984 and 1983. During 1985 the company opened 114 stores and closed 170; the closed stores including 125 from continuing operations. For ongoing operations, retail store area increased by 1.7 million square feet during 1985. The number and average size of stores at year-end 1985 were as follows:

| | Number | Ave. Size Sq. Ft. |
|---|---|---|
| Conventional supermarkets | 1,515 | 25,200 |
| Superstores (over 35,000 sq. ft.) | 651 | 41,200 |
| Liquor Barns | 103 | 19,500 |
| Food Barns | 63 | 32,400 |
| Sperry-Rehmat stores | 20 | 74,000 |
| Other specialty stores | 13 | 23,000 |
| Total stores and overall average | 2,365 | 29,700 |

Capital expenditures in 1986 are projected to be $660 million and 90 store openings are planned. The company obtains most of its capital from operations and mortgage financing. In 1985, 1984 and 1983, cash provided from operations was $703.6, $411.1 and $476.0 million, respectively.

## Consolidated Statements of Income

*Safeway Stores, Incorporated and Subsidiaries*

*For the 52 weeks ended December 28, 1985, December 29, 1984 and December 31, 1983 (in thousands, except per share amounts)*

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| Sales | $19,650,542 | $19,642,201 | $18,585,217 |
| Cost of sales | 14,872,247 | 15,004,547 | 14,249,843 |
| Gross profit | 4,778,295 | 4,637,654 | 4,335,374 |
| Operating and administrative expenses | 4,350,635 | 4,214,443 | 3,920,736 |
| Operating profit | 427,660 | 423,211 | 414,638 |
| Interest expense | (172,906) | (151,263) | (134,270) |
| Gain on sale of foreign operations | 49,046 | | |
| Other income, net | 49,816 | 26,874 | 20,565 |
| Income before provision for income taxes | 353,616 | 298,822 | 300,933 |
| Provision for income taxes | 122,316 | 113,811 | 117,630 |
| Net income | $ 231,300 | $ 185,011 | $ 183,303 |
| Net income per share | $ 3.83 | $ 3.12 | $ 3.26 |

*See accompanying notes to the consolidated financial statements.*

## Consolidated Statements of Changes in Financial Position

*Safeway Stores, Incorporated and Subsidiaries*

*For the 52 weeks ended December 28, 1985, December 29, 1984 and December 31, 1983 (in thousands)*

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| **Cash provided from operations:** | | | |
| Net income | $231,300 | $185,011 | $183,303 |
| Charges (credits) to income not requiring (providing) cash: | | | |
| Depreciation and amortization | 333,398 | 295,290 | 264,553 |
| Gain on sale of Australian operations | (48,296) | | |
| Equity in earnings of affiliates | (8,100) | (1,890) | (140) |
| Deferred income taxes | 29,830 | 34,128 | 20,194 |
| LIFO charge (credit) | (5,566) | 29,275 | (444) |
| Accrued claims and other liabilities | 8,531 | 9,608 | (11,035) |
| (Increase) decrease in current assets: | | | |
| Receivables | (9,233) | (13,524) | (18,537) |
| Inventories at FIFO cost | (59,815) | (159,265) | (94,820) |
| Prepaid expenses and other current assets | (8,978) | 12,689 | 7,349 |
| Increase (decrease) in current liabilities: | | | |
| Payables and accruals | 230,035 | 42,424 | 93,761 |
| Income taxes payable | 11,510 | (22,650) | 31,824 |
| Total cash provided from operations | 704,616 | 411,096 | 476,008 |
| **Investment activities:** | | | |
| Additions to property | (621,758) | (701,678) | (541,238) |
| Retirements or sales of property | 131,079 | 113,091 | 90,296 |
| Proceeds from sale of foreign operations: | | | |
| Net working capital | (26,611) | | |
| Other net assets, at fair value | 135,220 | | |
| Investments in affiliated companies | (104,272) | (2,265) | (2,432) |
| Exchange rate effects on property and investments | 11,051 | 57,211 | 27,308 |
| Cumulative translation adjustments | (28,056) | (41,907) | (18,045) |
| Other | (9,185) | 6,806 | (9,691) |
| Net investment activities | (512,532) | (568,742) | (453,802) |
| **Financing activities:** | | | |
| Additions to long-term debt | 167,500 | 323,625 | 205,935 |
| Payments on long-term debt | (174,871) | (104,008) | (266,876) |
| Increase (decrease) in notes payable | 39,900 | (5,243) | (37,872) |
| Exchange rate effects on long-term debt | (6,000) | (14,576) | (7,576) |
| Increase in current maturities of long-term debt | 2,582 | 23,137 | 11,155 |
| Cash dividends on common stock | (98,135) | (90,371) | (80,961) |
| Proceeds from issuance of common stock | 28,467 | 25,936 | 168,962 |
| Other | (1,355) | (1,986) | (3,207) |
| Net financing activities | (41,912) | 156,514 | (10,440) |
| Increase (decrease) in cash and short-term investments | 150,172 | (1,132) | 11,766 |
| **Cash and short-term investments:** | | | |
| Beginning of year | 74,442 | 75,574 | 63,808 |
| End of year | $224,614 | $ 74,442 | $ 75,574 |

*See accompanying notes to the consolidated financial statements.*

## Consolidated Balance Sheets

*Safeway Stores, Incorporated and Subsidiaries*

*As of December 28, 1985, December 29, 1984 and December 31, 1983*
*(in thousands, except per share amounts)*

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| **Assets** | | | |
| Current assets: | | | |
| Cash | $ 54,593 | $ 49,179 | $ 51,682 |
| Short-term investments | 170,021 | 25,263 | 23,892 |
| Receivables | 111,870 | 105,166 | 91,642 |
| Merchandise inventories: | | | |
| FIFO cost | 1,878,281 | 1,881,525 | 1,722,260 |
| Less LIFO reductions | 312,715 | 318,281 | 289,006 |
| | 1,565,566 | 1,563,244 | 1,433,254 |
| Prepaid expenses and other current assets | 124,431 | 118,537 | 128,676 |
| Total current assets | 2,026,481 | 1,861,389 | 1,729,146 |
| Property: | | | |
| Land | 247,769 | 236,876 | 210,427 |
| Buildings | 431,410 | 345,001 | 305,006 |
| Leasehold improvements | 600,091 | 557,504 | 459,711 |
| Fixtures and equipment | 2,164,072 | 2,023,914 | 1,789,136 |
| Transport equipment | 186,831 | 186,485 | 173,576 |
| Property under capital leases | 1,010,277 | 1,144,409 | 1,155,493 |
| | 4,640,450 | 4,494,189 | 4,093,349 |
| Less accumulated depreciation and amortization | 2,003,752 | 1,894,333 | 1,731,138 |
| Total property, net | 2,636,698 | 2,599,856 | 2,362,211 |
| Investments in affiliated companies | 122,195 | 27,251 | 26,519 |
| Other assets | 55,237 | 48,733 | 56,487 |
| Total assets | $ 4,840,611 | $ 4,537,229 | $ 4,174,363 |



*See accompanying notes to the consolidated financial statements.*

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| **Liabilities and Stockholders' Equity** | | | |
| Current liabilities: | | | |
| Notes payable | $ 80,848 | $ 44,913 | $ 50,156 |
| Current obligations under capital leases | 43,396 | 45,427 | 45,841 |
| Current maturities of notes and debentures | 52,049 | 48,274 | 24,723 |
| Accounts payable | 1,151,426 | 1,038,268 | 1,017,094 |
| Accrued salaries and wages | 167,798 | 167,739 | 163,021 |
| Other accrued expenses | 201,357 | 170,905 | 154,373 |
| Income taxes payable | 27,827 | 20,431 | 43,081 |
| Total current liabilities | 1,724,701 | 1,535,957 | 1,498,289 |
| Long-term debt: | | | |
| Obligations under capital leases | 625,551 | 746,178 | 765,307 |
| Notes and debentures | 689,470 | 646,532 | 422,362 |
| Total long-term debt | 1,315,021 | 1,392,710 | 1,187,669 |
| Accrued claims and other liabilities | 178,275 | 139,539 | 98,051 |
| Total liabilities | 3,217,997 | 3,068,206 | 2,784,009 |
| Stockholders' equity: | | | |
| Common stock - $1.66⅔ par value | | | |
| Authorized 150,000, 150,000 and 75,000 shares | | | |
| Outstanding 60,846, 59,854 and 58,760 shares | 101,411 | 99,756 | 97,933 |
| Additional paid-in capital | 273,776 | 246,964 | 222,851 |
| Cumulative translation adjustments | (164,035) | (155,994) | (114,087) |
| Retained earnings | 1,411,462 | 1,278,297 | 1,183,657 |
| Total stockholders' equity | 1,622,614 | 1,469,023 | 1,390,354 |
| Total liabilities and stockholders' equity | $ 4,840,611 | $ 4,537,229 | $ 4,174,363 |

## Consolidated Statements of Stockholders' Equity

*Safeway Stores, Incorporated and Subsidiaries*

| *For the 52 weeks ended December 28, 1985, December 29, 1984 and December 31, 1983 (in thousands, except per share amounts)* | Common Stock | | *Additional Paid-in Capital* | *Cumulative Translation Adjustments* | *Retained Earnings* |
|---|---|---|---|---|---|
| | *Shares* | *Amount* | | | |
| Balance, January 1, 1983 | 26,150 | $ 43,583 | $ 64,573 | $ (96,042) | $1,124,981 |
| Net income | | | | | 183,303 |
| Cash dividends ($1.425 per share) | | | | | (80,961) |
| Translation adjustments | | | | (18,045) | |
| Stock issued under stock option plans (pre-split) | 50 | 84 | 1,841 | | |
| Stock issued in 2-for-1 split | 26,200 | 43,666 | | | (43,666) |
| Stock issued under: | | | | | |
| Public offering | 5,500 | 9,167 | 136,729 | | |
| Dividend reinvestment plan | 564 | 940 | 13,403 | | |
| Stock option plans | 150 | 250 | 2,470 | | |
| Tax Reduction Act Stock Ownership Plan | 146 | 243 | 3,835 | | |
| Balance, December 31, 1983 | 58,760 | 97,933 | 222,851 | (114,087) | 1,183,657 |
| Net income | | | | | 185,011 |
| Cash dividends ($1.525 per share) | | | | | (90,371) |
| Translation adjustments | | | | (41,907) | |
| Stock issued under: | | | | | |
| Dividend reinvestment plan | 950 | 1,583 | 21,734 | | |
| Stock option plans | 144 | 240 | 2,379 | | |
| Balance, December 29, 1984 | 59,854 | 99,756 | 246,964 | (155,994) | 1,278,297 |
| Net income | | | | | 231,300 |
| Cash dividends ($1.625 per share) | | | | | (98,135) |
| Translation adjustments | | | | (28,056) | |
| Translation adjustments realized on sale of foreign operations | | | | 20,015 | |
| Stock issued under: | | | | | |
| Dividend reinvestment plan | 753 | 1,256 | 21,899 | | |
| Stock option plans | 239 | 399 | 4,913 | | |
| Balance, December 28, 1985 | 60,846 | $101,411 | $273,776 | $(164,035) | $1,411,462 |

*See accompanying notes to the consolidated financial statements*

## Note A - Summary of Significant Accounting Policies

### Fiscal Year:

The fiscal year for Safeway Stores, Incorporated (the company) and its Canadian subsidiary ends on the Saturday nearest December 31. The fiscal year of the company's United Kingdom subsidiary ends on the Saturday nearest September 30, to allow sufficient time to gather information for U.S. reporting purposes.

### Basis of Consolidation:

The consolidated financial statements include the accounts of all significant subsidiaries. All intercompany transactions have been eliminated in consolidation. Investments in affiliates which are not majority owned are included in the financial statements at the company's equity therein.

### Translation of Foreign Currencies:

Assets and liabilities of the company's foreign subsidiaries are translated into U.S. dollars at fiscal year-end rates of exchange, and income and expenses are translated at average rates during the year.

Translation adjustments are included in "cumulative translation adjustments," a separate component of stockholders' equity. Gains or losses from foreign currency transactions (transactions denominated in a currency other than the entity's local currency) are included in income. In 1985, foreign currency transactions resulted in a gain of $0.9 million compared with losses for 1984 and 1983 of $2.4 and $2.5 million, respectively.

### Provision For Income Taxes:

The provision for income taxes recognizes the tax effect of all transactions entering into the determination of income for financial statement reporting purposes irrespective of when such transactions are reportable for income tax purposes. Deferred income taxes are provided to recognize differences in the timing of income and expense for tax and financial reporting purposes. Investment tax credits reduce the provision for income taxes in the year in which the credits arise.

### Merchandise Inventories:

Approximately 68 percent of consolidated merchandise inventories are valued on a last-in, first-out (LIFO) basis at December 28, 1985. Inventories not valued on a LIFO basis are valued at the lower of cost on a first-in, first-out (FIFO) basis or replacement market. Inventories on a FIFO basis include meat and produce in the U.S. and all inventories of foreign subsidiaries.

Application of the LIFO method resulted in a $5.6 million credit to cost of sales in 1985, a $29.3 million charge in 1984 and a $0.4 million credit in 1983. In all three years, fourth-quarter adjustments reduced the LIFO charges accumulated through the first 36 weeks of the year to reflect the actual impact of applying the LIFO method for the full year as determined at year-end. The adjustments increased fourth quarter pretax earnings by $29.8 million in 1985, $2.4 million in 1984 and $23.8 million in 1983.

### Property and Depreciation:

Property is stated at historical cost. Interest incurred in connection with construction in progress is capitalized. Depreciation is computed for financial reporting purposes under the straight-line method using the following lives:

| | |
|---|---|
| Stores and other buildings | 20 - 40 years |
| Fixtures and equipment | 3 - 20 years |
| Transport equipment | 6 - 14 years |

Leasehold improvements include buildings constructed on leased land and improvements to leased buildings. Buildings and major improvements are amortized under the straight-line method over the shorter of the remaining period of the lease or the estimated useful lives of the assets.

Property under capital leases is amortized under the straight-line method over the terms of the leases. Accumulated amortization of property under capital leases was $493.9, $515.2 and $502.9 million at year-ends 1985, 1984 and 1983, respectively.

Depreciation and amortization expense for property of $331.3 million in 1985, $293.7 million in 1984 and $263.4 million in 1983 included amortization of property under capital leases of $53.8, $54.9 and $55.2 million, respectively.

### Pre-Opening Costs:

Costs related to opening new stores are expensed as incurred.

### Self-Insurance:

The company is self-insured for workers' compensation, automobile and general liability costs. The self-insurance liability is based upon a review by the company and an independent actuary of claims filed and an estimate of claims incurred but not yet filed.

The company is also self-insured to provide post-retirement health care and death benefits to retirees. The cost of these benefits is recognized as expense as claims are paid.

### Net Income Per Share:

Net income per share is determined by dividing consolidated net income by the average number of common shares outstanding during the year.

### Reclassifications:

Certain amounts for 1984 and 1983 have been reclassified to conform with 1985 presentation.

**Note B - Sale of Foreign Operations**

During 1985, the company sold selected foreign operations, recognizing a pretax gain of $49.0 million ($34.5 million after-tax or $0.58 per share). On the sale of the Australian operations the company acquired a 20% interest in Woolworths Limited, the largest food retailer in Australia. The company's investment in Woolworths is accounted for under the equity method. The company also sold its operations in West Germany and Toronto.

**Note C -Taxes on Income**

The components of the provision for income taxes included in the consolidated statements of income were as follows (in thousands):

| | *1985* | *1984* | *1983* |
|---|---|---|---|
| Current: | | | |
| Federal | $ 27,999 | $ 21,057 | $ 23,589 |
| State | 9,622 | 9,161 | 12,217 |
| Foreign | 50,824 | 49,465 | 61,630 |
| | 88,445 | 79,683 | 97,436 |
| Deferred: | | | |
| Federal | 30,901 | 30,321 | 15,644 |
| State | 2,222 | 2,002 | 862 |
| Foreign | 748 | 1,719 | 969 |
| | 33,871 | 34,128 | 17,475 |
| | $122,316 | $113,811 | $114,911 |

Non-current deferred tax credits of $82.0 and $47.5 million were included in accrued claims and other liabilities at year-ends 1985 and 1984, respectively. In 1983 a non-current deferred tax charge of $4.8 million was included in other assets. Current deferred tax charges of $25.4, $25.0 and $22.5 million were included in prepaid expenses and other current assets in those years.

The primary components of deferred income tax expense were as follows (in thousands):

| | *1985* | *1984* | *1983* |
|---|---|---|---|
| Accelerated depreciation | $ 23,860 | $ 27,230 | $ 23,191 |
| Tax benefits acquired through tax leases | 11,848 | 12,456 | 12,287 |
| Gain on sale of Australian operations | 6,109 | | |
| Accrued claims | (478) | 3,179 | (2,830) |
| Capitalized leases | (330) | (3,770) | (4,213) |
| Compensation plans | (1,254) | (2,892) | (5,456) |
| Repairs expense | (21) | 435 | (5,169) |
| Other, net | (5,863) | (6,610) | (1,335) |
| | $ 33,871 | $ 34,128 | $ 17,475 |

Undistributed U.S. earnings of Canadian subsidiaries (the source of consolidated retained earnings) are considered to be indefinitely reinvested and no provision for U.S. income taxes or foreign withholding taxes on such earnings has been made. Tax provision has been made for income taxes which would be payable if earnings not yet distributed through year-end 1985 were distributed to the parent company since it is the intention of management to make no such distributions. The undistributed earnings on which the company has not provided for income taxes were $710.9, $533.5 and $349.1 million at year-ends 1985, 1984 and 1983, respectively.

U.S. and Canadian corporate income tax returns for all years prior to 1980 and 1977, respectively, have been reviewed by taxing jurisdictions. Substantially all deductions which have been or may ultimately be disallowed are timing differences and will be claimed as deductions in future years through lower income taxes and reduced reported earnings.

A reconciliation of the U.S. federal statutory income tax rate to the company's effective income tax rate follows:

| | *1985* | *1984* | *1983* |
|---|---|---|---|
| Statutory federal income tax rate | 46.0% | 46.0% | 46.0% |
| U.S. investment tax credit | (4.6) | (3.1) | (3.3) |
| Difference between statutory and foreign effective rates | (3.3) | (2.8) | (3.4) |
| Payroll based tax credit certificates and ownership plans | (1.9) | (1.7) | (1.7) |
| Gain on sale of Australian operations | (1.9) | | |
| State taxes on income less sales of losses | 1.8 | 1.6 | 1.6 |
| Other, net | (1.5) | (1.0) | (0.8) |
| Effective income tax rate | 34.6% | 39.0% | 39.4% |

Income tax expense on financial statement purposes was reduced by investment tax credits of $15.3, $16.5 and $14.0 million in 1985, 1984 and 1983, respectively. These amounts were reduced by $6.9, $8.0 and $7.2 million respectively for related tax basis adjustments and investment tax credit recapture.

**Note D - Financing**

Short-term

At year-end 1985, the company had lines of credit with a number of major U.S. and foreign banks amounting to $455 million, of which $385 million is maintained to back U.S. commercial paper borrowings. Compensating balances in support of the lines of credit are not significant and there are no legal restrictions on withdrawals. The company pays annual commitment fees of ⅛th percent on the unused portion of credit facilities to support commercial paper issuance.

Commercial paper borrowings at year-end 1985 amounted to $144.3 million of which $30.0 million were expected to be continually refinanced for a period beyond one year and were reclassified as long-term debt. Under interest rate swap agreements an additional $60.0 million of commercial paper borrowings were reclassified as long-term debt. The interest rate swap agreements enabled the company to obtain long-term financing at rates lower than long-term borrowing rates directly available to the company at the time of the agreement.

Long-term

Long-term debt was comprised of the following (in thousands):

| | *1985* | *1984* | *1983* |
|---|---|---|---|
| Mortgage notes payable, secured | $416,379 | $363,627 | $263,250 |
| Commercial paper and bank borrowings | 90,000 | 100,000 | 49,000 |
| Industrial development revenue bonds | 68,245 | 57,680 | 33,132 |
| 7.40% sinking fund debentures, unsecured, due in installments through 1997 | 18,209 | 37,255 | 37,780 |
| Other notes payable, unsecured | 148,686 | 136,244 | 63,923 |
| | 741,519 | 694,806 | 447,085 |
| Less current maturities | 52,049 | 48,274 | 24,723 |
| Long-term debt | $689,470 | $646,532 | $422,362 |

The mortgage notes payable are secured by properties which are included in the balance sheet at their net book value of $319.6 million. Mortgage notes have terms ranging from 1 to 25 years and bear interest at 5 to 16 percent.

In 1985 the company completed an in-substance defeasance on $18.5 million of the 7.40% debentures by placing funds in an irrevocable trust sufficient to cover all future principal and interest payments on the debentures. A gain of $3.2 million was recognized on the defeasance. The remaining debentures require annual sinking fund payments of $1.6 million. Under the agreement covering the debentures, $1.06 billion of the retained earnings as of year-end 1985 was free of restrictions for dividend payments and acquisitions of common stock. Restrictions include a limitation on the creation of additional debt.

At year-end 1984, the company had completed industrial development revenue bond financings of $88.0 million of which $71.9 and $57.9 million had been released to the company at year-ends 1985 and 1984, respectively. The bonds have terms ranging from 10 to 25 years and bear interest at 6 to 14 percent. No new financing of this type was obtained during 1985.

Aggregate annual maturities of long-term debt for the five years beyond 1985 are (in thousands):

| | |
|---|---|
| 1986 | $ 52,049 |
| 1987 | 59,772 |
| 1988 | 59,217 |
| 1989 | 102,959 |
| 1990 | 45,040 |

Subsequent to year-end, the company's United Kingdom subsidiary issued $57.1 million in unsecured debt. The debt has an effective interest rate of 11.25%. Interest is payable on a semi-annual basis with the principal maturing in the year 2011.

**Note E -Lease Obligations**

The company and its subsidiaries occupy primarily leased premises. Company premises and equipment were covered by 3,414 leases at year-end 1985 including 1,210 which are capitalized for financial reporting purposes.

Most leases have renewal options with terms and conditions similar to the original lease. Of all the leases 1,452 can be cancelled by the company by offer to purchase the properties at original cost less amortization.

The following schedule shows future minimum rental payments required under leases that have noncancellable lease terms in excess of one year as of year-end 1985 (in thousands):

| | Capital Leases | Operating Leases |
|---|---|---|
| 1986 | $ 106,574 | $ 155,165 |
| 1987 | 102,625 | 152,357 |
| 1988 | 98,370 | 144,194 |
| 1989 | 95,456 | 140,098 |
| 1990 | 95,660 | 136,997 |
| Later years | 916,497 | 1,563,636 |
| Total minimum lease payments | 1,415,182 | $ 2,292,447 |
| Less executory costs | 16,344 | |
| Net minimum lease payments | 1,398,838 | |
| Less amounts representing interest | 729,891 | |
| Present value of net minimum lease payments | 668,947 | |
| Less current obligations | 43,396 | |
| Long-term obligations | $ 625,551 | |

In addition to minimum lease payments, contingent rentals may be paid under certain store leases on the basis of the stores' sales in excess of stipulated amounts. Contingent rentals on capital leases amounted to $6.9 million in 1985, $8.9 million in 1984 and $10.4 million in 1983. The following schedule shows the composition of total rental expense for all operating leases (in thousands):

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| Property leases: | | | |
| Minimum rentals | $180,885 | $172,629 | $156,247 |
| Contingent rentals | 9,653 | 10,299 | 10,296 |
| Less rentals from subleases | (18,320) | (15,472) | (11,589) |
| | 172,218 | 167,456 | 154,954 |
| Equipment leases | 30,141 | 27,682 | 26,071 |
| | $202,359 | $195,138 | $181,025 |

**Note F - Interest Expense**

Interest expense consisted of the following (in thousands):

| | 1985 | 1984 | 1983 |
|---|---|---|---|
| Notes and debentures | $ 83,598 | $ 63,585 | $ 48,201 |
| Obligations under capital leases | 76,476 | 75,060 | 74,031 |
| Commercial paper and bank borrowings | 13,882 | 16,544 | 16,329 |
| Other | 4,542 | 3,011 | 3,017 |
| | 178,498 | 158,200 | 141,578 |
| Less capitalized interest | 5,592 | 6,937 | 7,308 |
| | $172,906 | $151,263 | $134,270 |

**Note G - Profit-Sharing and Stock Option Plans**

The company has profit-sharing plans for eligible U.S. and Canadian employees. Contributions charged to income were $16.2 million in 1985, $17.5 million in 1984 and $16.3 million in 1983.

The company also contributes to U.S. employee stock ownership plans and receives a tax credit equal to the amount contributed. The expense under these plans was $11.4, $9.2 and $10.8 million in 1985, 1984 and 1983, respectively.

The company's qualified "incentive" and non-qualified stock option plans authorize the issuance of 3.0 million shares of the company's common stock. At year-end 1985 there were 762,000 unoptioned shares available for future grants. The options are exercisable at the fair market value of the company's common stock on the date of the grant. Options become exercisable at intervals during the first three years after the date of the grant and expire 10 years after the date of the grant. The plans allow for stock appreciation rights (SAR's) to be granted in tandem with certain stock options. Upon exercise of SAR's, the holder surrenders the related options and receives in cash the excess of the then fair market value of the stock over the option price.

The following summarizes stock option activity during each of the last three years (in thousands, except option price):

| | Shares | SARs | Option Price |
|---|---|---|---|
| Outstanding, year-end 1982 | 1,389 | 546 | $14.31-15.81 |
| Granted | 838 | 240 | 24.56-27.56 |
| Exercised | (251) | (235) | 14.31-15.81 |
| Cancelled | (263) | (2) | 14.31-15.81 |
| Outstanding, year-end 1983 | 1,713 | 549 | 14.31-27.56 |
| Granted | 18 | 17 | 22.31-27.19 |
| Exercised | (144) | (135) | 14.31-15.81 |
| Cancelled | (187) | (17) | 14.31-27.56 |
| Outstanding, year-end 1984 | 1,400 | 414 | 14.31-27.56 |
| Granted | 548 | 320 | 31.50 |
| Exercised | (239) | (150) | 14.31-27.56 |
| Cancelled | (173) | (12) | 14.31-27.56 |
| Outstanding, year-end 1985 | 1,536 | 572 | $14.31-31.50 |

At year-end 1985 the weighted average option price for outstanding stock options was $26.67. Of the outstanding options at year-end 1985, 771,000 were exercisable at an option price of $14.31-27.56. The company recognized compensation expense of $3.8, $0.5 and $3.5 million in 1985, 1984 and 1983, respectively, relating to stock appreciation rights.

**Note H - Employee Pension Benefits**

The company and its subsidiaries participate in various pension plans under collective bargaining agreements and maintain pension plans covering other eligible employees.

Contributions charged to income under collective bargaining agreements were $129.1 million in 1985, $125.6 million in 1984 and $122.0 million in 1983. Under U.S. legislation regarding multi-employer pension plans, a company is required to continue funding its proportionate share of a plan's unfunded vested benefits in the event of withdrawal (as defined by the legislation) from a plan or plan termination. The company participates in approximately 80 multi-employer pension plans and the potential obligation as a participant in these plans may be significant. However, the information required to determine the total amount of this contingent obligation, as well as the total amount of accumulated benefits and net assets of such plans, is not readily available.

Other plans consist of contributory, trusteed pension plans for eligible employees not covered by collective bargaining agreements and a supplemental pension plan for senior executives. The aggregate charges to income for all such plans were $5.5 million in 1985, $6.9 million in 1984 and $6.6 million in 1983.

The actuarial present values of accumulated plan benefits for the U.S. pension plan as of December 31, 1984, 1983, and 1982 were $233.0, $205.2 and $179.0 million as to vested benefits and $5.6, $5.2 and $4.7 million as to non-vested benefits, respectively. The net assets available for benefits at those dates amounted to $509.7, $478.5 and $410.8 million, respectively. The assumed rate of return used to determine the actuarial present value of accumulated plan benefits was 8.0 percent. The "pro-rata unit credit" method is used to determine pension obligations for funding and accounting purposes. The company's foreign pension plans and supplemental pension plan for senior executives are not required to report to U.S. government agencies pursuant to the Employee Retirement Income Security Act. Accordingly, the actuarial present values of accumulated plan benefits, as disclosed for the U.S. pension plan, have not been determined for those plans. The net assets of foreign plans are sufficient to fund vested benefits. The company has purchased cost-recovery life insurance to fund its obligations under the supplemental pension plan for senior executives.

**Note I - Commitments**

The company has commitments under contracts for the purchase of property and equipment and for the construction of buildings. Portions of such contracts not completed at year-end are not reflected in the consolidated financial statements. These unrecorded commitments amounted to approximately $68 million at year-end 1985.

**Note J - Contingent Liabilities - Litigation**

There are pending against the company, as of March 3, 1986, various claims and lawsuits arising in the normal course of the company's business, some of which seek damages in very large amounts, as well as other relief which, if granted, would require very large expenditures. Included are suits claiming violation of certain civil rights laws, some of which purport to be class actions.

Although the amount of liability at year-end 1985 with respect to all of the above matters cannot be ascertained, management is of the opinion that any resulting liability will not materially affect the company's consolidated income or financial position.

**Note K - Stock Rights**

On February 12, 1986 the board of directors declared a dividend of one common share purchase right on each outstanding share of common stock distributable to stockholders of record on February 24, 1986. The rights will become exercisable if and when any person acquires 20% or more of the company's outstanding common stock, or announces an offer which would result in such person acquiring 30% or more of the company's common stock. The rights will expire February 26, 1996, and may be redeemed by the company for $0.05 per right at any time before a person acquires 20% or more of the company's common stock. If, following such acquisition, there is a merger or other business combination involving the company, each right will entitle its holder to buy a number of shares of common stock of the acquiring company (or of the company, if the company is the surviving entity) having a market value of twice the $100 exercise price of each right.

**Note L - Supplementary Information on Inflation and Changing Prices (Unaudited)**

The company's primary financial statements are stated on the basis of historical costs. The statements reflect the actual transactions expressed in the number of dollars earned or expended without regard to changes in the purchasing power of the dollar. The following supplementary information attempts to measure the effect of changes in specific prices on the results of operations by restating historical costs to amounts which approximate the current costs to the company of producing or replacing inventories and property.

The computed net income for 1985 under current cost accounting includes restatements of merchandise costs, depreciation and amortization expense. The effects of inflation on merchandise costs have already been recognized in the historical financial statements to the extent that the LIFO method of accounting is used for approximately 68 percent of merchandise inventories.

The provision for income taxes has not been restated to a current cost basis because inflation adjustments are not deductible for income tax purposes.

The purchasing power gain results from an excess of net monetary liabilities over monetary assets. In periods of general inflation monetary assets lose purchasing power because such assets will buy fewer goods. Conversely monetary liabilities gain purchasing power since the liabilities will be repaid with dollars of reduced purchasing power.

In 1985, the current costs of merchandise inventories and property increased by $418.7 million, whereas those assets increased by $225.4 million as a result of general inflation. Thus, the year's increase in inventories and property due to current cost exceeded the increase in general inflation by $193.3 million, indicating a greater increase in the company's specific price indices than the rate of general inflation. At year-end 1985, the current cost of merchandise inventories was $1.9 billion and the current cost of net property was $3.8 billion.

Current cost accounting methods involve the use of assumptions, estimates and subjective judgments, and the results should not be viewed as precise measurements of the effects of inflation.

**Supplementary Financial Data Adjusted for the Effects of Changing Prices**

| (in millions) | 1985 | |
|---|---|---|
| | *As Reported in the Consolidated Statement of Income (Historical Cost)* | *Adjusted for Changes in Specific Prices (Current Cost)* |
| Sales | $19,650 | $19,650 |
| Cost of sales | 14,872 | 14,903 |
| Other expenses, net | 4,425 | 4,461 |
| Income before provision for income taxes | 353 | 286 |
| Provision for income taxes | 122 | 122 |
| Net income | $ 231 | 164 |
| Gain from the change in purchasing power of net monetary liabilities | | 103 |
| Net income including purchasing power gain | | $ 267 |
| Depreciation and amortization expense * | $ 333 | $ 422 |

* *Allocated between cost of sales and other expenses in the determination of net income.*

Amounts shown below for 1985 reflect the current cost assumption discussed above. Prior year amounts are adjusted to reflect the relationship between the average CPI-U for each of the years indicated as measured against the average CPI-U for 1985.

## Five-Year Comparison of Selected Financial Data Adjusted for the Effects of Changing Prices

(in dollars of 1985 average purchasing power)

| | 1985 | 1984 | 1983 | 1982 | 1981 |
|---|---|---|---|---|---|
| Sales | $19,650 | $20,343 | $20,068 | $19,652 | $19,611 |
| Net income (loss) | 164 | 57 | 22 | 23 | (50) |
| Net income (loss) per share of common stock | 2.72 | .96 | .40 | .45 | (.96) |
| Gain from the change in purchasing power of net monetary liabilities | 103 | 100 | 96 | 93 | 216 |
| Net income including gain in purchasing power | 267 | 158 | 118 | 116 | 166 |
| Increase in the current costs of merchandise inventories and property over (under) the increase due to general inflation | 193 | (140) | 83 | (161) | (280) |
| Net assets at year-end | 3,034 | 2,951 | 3,045 | 2,762 | 2,913 |
| Cash dividends per share of common stock | 1.625 | 1.579 | 1.539 | 1.477 | 1.538 |
| Market price per share of common stock at year-end | 36.62 | 28.48 | 27.80 | 25.49 | 15.67 |
| Average Consumer Price Index (CPI-U) | 322.2 | 311.1 | 298.4 | 289.1 | 272.4 |

*Note: Dollars in millions except per share amounts.*

## Note M - Quarterly Information (Unaudited)

(in thousands, except per share amounts)

| | First 12 Weeks | Second 12 Weeks | Third 12 Weeks | Last 16 Weeks* |
|---|---|---|---|---|
| **1985** | | | | |
| Sales | $4,551,963 | $4,548,439 | $4,564,158 | $5,985,982 |
| Gross profit | 1,067,986 | 1,110,271 | 1,114,769 | 1,485,269 |
| Operating profit | 74,245 | 115,087 | 104,714 | 133,614 |
| Gain on sale of foreign operations | | | 48,295 | 751 |
| Net income | 25,670 | 49,908 | 89,130 | 66,592 |
| Net income per share | .43 | .83 | 1.48 | 1.09 |
| Cash dividends per share | .40 | .40 | .40 | .425 |
| Price range, New York Stock Exchange | 26⅞-34⅜ | 29⅝-33½ | 30-34⅜ | 29⅝-37⅛ |
| **1984** | | | | |
| Sales | $4,402,684 | $4,525,660 | $4,583,644 | $6,130,213 |
| Gross profit | 1,014,275 | 1,076,082 | 1,082,311 | 1,464,986 |
| Operating profit | 64,442 | 107,548 | 91,237 | 159,984 |
| Net income | 22,013 | 47,544 | 38,736 | 76,718 |
| Net income per share | .37 | .81 | .65 | 1.29 |
| Cash dividends per share | .375 | .375 | .375 | .40 |
| Price range, New York Stock Exchange | 24⅛-27½ | 21⅛-25½ | 21¼-29 | 24⅜-29¼ |
| **1983** | | | | |
| Sales | $4,219,229 | $4,287,238 | $4,300,321 | $5,778,429 |
| Gross profit | 955,030 | 991,805 | 999,390 | 1,389,149 |
| Operating profit | 65,516 | 89,586 | 98,955 | 160,581 |
| Net income | 23,883 | 37,121 | 47,122 | 75,177 |
| Net income per share | .46 | .68 | .82 | 1.30 |
| Cash dividends per share | .35 | .35 | .35 | .375 |
| Price range, New York Stock Exchange | 24¼-27⅝ | 24½-30 | 23¾-27⅛ | 24¼-28⅞ |

*Note: Dividends are for calendar quarters.*
* *See Note A - Merchandise Inventories.*

**Note N - Financial Information by Geographic Area**

| (in thousands) | 1985 | 1984 | 1983 |
|---|---|---|---|
| United States* | | | |
| Sales | $15,389,928 | $15,042,760 | $14,056,832 |
| Gross profit | 3,886,144 | 3,691,222 | 3,400,517 |
| Operating and administrative expenses | 3,591,382 | 3,409,980 | 3,144,434 |
| Operating profit | 294,762 | 281,242 | 256,083 |
| Income before provision for income taxes | 175,618 | 165,974 | 154,967 |
| Provision for income taxes | 56,914 | 62,143 | 58,658 |
| Net income | 118,704 | 103,831 | 96,309 |
| Net working capital including merchandise inventories at FIFO cost | 414,702 | 501,554 | 384,897 |
| Less LIFO reductions | 312,715 | 318,281 | 289,006 |
| Net working capital | 101,987 | 183,273 | 95,891 |
| Total assets | 3,730,899 | 3,449,840 | 3,075,432 |
| Net assets | 993,417 | 925,055 | 845,623 |
| Cumulative translation adjustments | — | 3,156 | 1,339 |
| Canada | | | |
| Sales | $ 2,464,676 | $ 2,641,738 | $ 2,682,836 |
| Gross profit | 550,604 | 573,077 | 590,412 |
| Operating and administrative expenses | 472,626 | 493,355 | 491,511 |
| Operating profit | 77,978 | 79,722 | 98,901 |
| Income before provision for income taxes | 76,237 | 78,620 | 97,707 |
| Provision for income taxes | 30,211 | 30,517 | 38,949 |
| Net income | 46,026 | 48,103 | 58,758 |
| Net working capital | 233,198 | 163,286 | 175,527 |
| Total assets | 697,755 | 653,632 | 654,494 |
| Net assets | 426,252 | 434,067 | 426,178 |
| Cumulative translation adjustments | (115,976) | (86,993) | (62,167) |
| Other Foreign+ | | | |
| Sales | $ 1,795,938 | $ 1,957,703 | $ 1,845,549 |
| Gross profit | 341,547 | 373,355 | 344,445 |
| Operating and administrative expenses | 286,627 | 311,108 | 284,791 |
| Operating profit | 54,920 | 62,247 | 59,654 |
| Income before provision for income taxes | 101,761 | 54,228 | 48,259 |
| Provision for income taxes | 35,191 | 21,151 | 20,023 |
| Net income | 66,570 | 33,077 | 28,236 |
| Net working capital deficit | (33,405) | (21,127) | (40,561) |
| Total assets | 411,957 | 433,757 | 444,437 |
| Net assets | 202,945 | 109,901 | 118,553 |
| Cumulative translation adjustments | (48,059) | (72,157) | (53,259) |

** Reflects use of the LIFO method of valuing certain inventories*
*+ See note B - Sale of Foreign Operations*

## Management's Responsibility for Financial Statements

The consolidated financial statements of Safeway Stores, Incorporated and its subsidiaries have been prepared in accordance with generally accepted accounting principles and necessarily include amounts that are based on management's best estimates and judgments. Management is responsible for the integrity and objectivity of the data in these statements. Financial information elsewhere in this annual report is consistent with that in the financial statements.

To fulfill its responsibilities, management has developed and maintains a strong system of internal accounting controls. There are inherent limitations in any control system in that the cost of maintaining a control should not exceed the benefits to be derived. However, management believes the controls in use are sufficient to provide reasonable assurance that assets are safeguarded from loss or unauthorized use and that the financial records are reliable for preparing the financial statements. The controls are supported by careful selection and training of qualified personnel, by the appropriate division of responsibilities, by communication of written policies and procedures throughout the company, and by an extensive program of internal audits.

Peat, Marwick, Mitchell & Co., independent certified public accountants, whose report follows the consolidated financial statements, are engaged to provide an independent opinion regarding the fair presentation in the financial statements of the company's financial condition and results of operations. They obtain an understanding of the company's systems and procedures sufficient to provide them reasonable assurance that the financial statements are neither misleading nor contain material errors.

The board of directors, through its audit committee which is composed of outside directors, is responsible for assuring that management fulfills its responsibilities in the preparation of the financial statements. The board, on the recommendation of the audit committee and in accordance with stockholder approval, selects and engages the independent accountants. The audit committee meets with the independent accountants to review the scope of the annual audit and any recommendations they have for improvements in the company's internal accounting controls. To assure independence, the independent accountants have free access to the audit committee and may confer with them without management representation present.

## Accountants' Report

**Peat, Marwick, Mitchell & Co.**

To the Board of Directors and Stockholders
Safeway Stores, Incorporated:

We have examined the consolidated balance sheets of Safeway Stores, Incorporated and subsidiaries as of December 28, 1985, December 29, 1984 and December 31, 1983 and the related consolidated statements of income, stockholders' equity and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the aforementioned consolidated financial statements present fairly the financial position of Safeway Stores, Incorporated and subsidiaries at December 28, 1985, December 29, 1984 and December 31, 1983 and the results of their operations and changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Peat, Marwick, Mitchell & Co.

Oakland, California
March 3, 1986

## Directors

Samuel H. Armacost
President and
Chief Executive Officer
BankAmerica Corporation

Peter C. Bawden
Chairman of the Board
Peter Bawden Drilling, Ltd.
(Oil and Gas Contract
Drilling and Production)

John F. Bookout
President and
Chief Executive Officer
Shell Oil Company

Percy Chubb, III
Executive Vice President
The Chubb Corporation
(Insurance)

James R. Harvey
Chairman, President and
Chief Executive Officer
Transamerica Corporation
(Insurance and Financial
Services)

Edward N. Henney
Executive Vice President

Mary Gardiner Jones
President
Consumer Interest Research
Institute

C. Robert Kemp
President and
Chief Executive Officer
Opportunity Funding
Corporation

Roger D. Lapham, Jr.
Chairman and
Managing Director
RAMA Corporation Ltd.
(Insurance Investment)

Merrill L. Magowan
President
Magowan Investment
Company
(Investment Adviser)

Peter A. Magowan
Chairman of the Board and
Chief Executive Officer

Steven Muller
President
The Johns Hopkins University

James A. Rowland
President and
Chief Operating Officer

John Sculley
Chairman, President and
Chief Executive Officer
Apple Computer, Inc.

Harry D. Sunderland
Executive Vice President

Marjorie S. Kinney Thomas
Chairman, President and
Chief Executive Officer
M.S. Kinney Corporation
(Marketing, Consulting and
Publishing)

William H. Webster
President
Webster Feed Lots
Webster Land and Cattle
Company

Brayton Wilbur, Jr.
Executive Vice President
Wilbur-Ellis Company
(Importing and Exporting)

## Executive Officers

* Peter A. Magowan
Chairman of the Board and
Chief Executive Officer

* James A. Rowland
President and
Chief Operating Officer

* Edward N. Henney
Executive Vice President
Supply Operations

* E. Richard Jones
Executive Vice President
Information Services
and Planning

* Harry D. Sunderland
Executive Vice President
Chief Financial Officer

John Bell
Group Vice President

John S. Kimball
Group Vice President

William D. Lowe
Group Vice President

William H. Maloney
Group Vice President

Donald J. Smith
Group Vice President
and Director of Marketing

Robert H. Kinnie
Vice President
Chairman, President and
Chief Executive Officer
Canada Safeway Limited

William M. Albers
Senior Vice President
Distribution

Robert E. Bradford
Senior Vice President
Public Affairs

F. J. Dale
Senior Vice President
Controller

Roderick W. Davis
Senior Vice President
Management Information
Systems

Philip G. Horton
Senior Vice President
Real Estate and Engineering

John L. Morris
Senior Vice President and
Corporate Economist

John L. Repass
Senior Vice President
Human Resources

Bernat Rosner
Senior Vice President—Law
Secretary and General
Counsel

Patrick S. Totman
Senior Vice President
Finance

## Other Officers

### Vice Presidents — Retail

Donald R. Cannon
John A. Cartales
Gerald V. Curtright
B. Raj Dogra
Dean M. Gantt
Donald L. Gates
Richard P. Hillery
Gene J. Lawson
Donald B. Pennington
Donald J. Phillips
Eugene V. Podoll
Wilber L. Schinner
Robert R. Taylor
George D. Unti
Ralph C. Ward
Richard F. Wilson

### Vice Presidents — Supply

Floyd D. Crowe
John D. Lyding
Harold T. Nelson
Walter J. Schoendorf
James T. Summers

### Vice Presidents — Service

Robert G. Backovich
Maurice Barron
Ronald Giglio
Gaylord Hanson
Timothy J. Hopkins
Gordon W. Jones
Milton K. Kegley
Wayne Leader
William W. Liedtke
LeRoy F. Ludwig
George D. Marshall
John W. Mench
William L. Morgan
Harvey K. Naito
Ronald K. Parmelee
Arthur L. Patch
Rayburn D. Pearce
John L. Prehn
Richard C. Stanton
Ronald F. Zachary

* Members, Office of the Chairman

Foreign Subsidiary Operations

Canada Safeway Limited
Robert H. Kinnie
Chairman of the Board
President and Chief Executive Officer

John Jope
Vice President and Retail Division Manager

Bruce S. Nicoll
Vice President and Retail Division Manager

Richard H. Parkyn
Vice President and Retail Division Manager

Henry R. Rempel
Vice President and Retail Division Manager

John Whyte
Vice President and Retail Division Manager

Safeway Food Stores Limited
(United Kingdom)
T. E. Spratt
Chairman, Managing Director and Retail Division Manager

Johs. Esmarch's EFTF A/S
(Denmark)
Niels Norregaard
General Manager

Empress Foods Limited
(Canada)
William A. Gough
President and Supply Division Manager

Lucerne Foods Limited
(Canada)
Thor Andreassen
President and Supply Division Manager

Joint Venture

Casa Ley, S.A.
(Mexico)
Juan Manuel Ley Lopez
Director General
W. F. Phinney
Safeway Management Representative

Management Contracts

Middle East
William W. Liedtke
Vice President and Middle East Area Manager

Equity Investment

Woolworths Limited
(Australia)
Sir Eric McClintock
Chairman of the Board

Executive Offices

Fourth and Jackson Streets
Oakland, California 94660
(415) 891-3000

Transfer Agent and Registrar

First National Bank of Boston
P.O. Box 644
Boston, Massachusetts 02102

10-K Report

A facsimile of Safeway's 1985 10-K Report filed with the Securities and Exchange Commission may be obtained by writing the Controller at our executive offices.

Accountants

Peat, Marwick, Mitchell & Co.

Annual Meeting

The 1986 Annual Meeting of Stockholders will be held on May 13, 1986. In connection with this meeting, proxies will be solicited by the management. A notice of the meeting, together with a proxy statement and a form of proxy, will be mailed April 4, 1986. This Annual Report does not constitute part of the proxy material.

*ROBERT A. MAGOWAN*
*1903-1985*

*Rarely are so many noble human qualities imbued in one individual as they were in Robert Anderson Magowan, former chairman, president and chief executive officer. A man of enormous talent, boundless energy, quiet dignity and great personal charm, he brought to this company an intense dedication of purpose.*

*Mr. Magowan's management tenure began in 1955, a dismal year for Safeway. By the time he retired as CEO at the end of 1970, net earnings had quintupled while sales had increased by more than 150 percent. A single share of our common stock held during this period grew to 5.65 times its original value on the strength of two splits, 12 dividend increases and a 380 percent rise in market price, adjusted for splits.*

*Richly blessed with vision and imagination, he was a guiding force in Safeway's emergence as the world's leading food retailer. Among his most notable achievements, he revitalized our founding commitment to customer satisfaction; he streamlined and decentralized administrative staff functions; he introduced professional management methods and creative merchandising techniques; and he was the architect of our expansion to overseas markets.*

*An exceedingly generous man, he had long been active in civic affairs and devoted much of his time to charitable and philanthropic endeavors, in this country and abroad. Among numerous honors and awards, Mr. Magowan was knighted four times, received two honorary doctorates and was appointed to a Presidential commission. Though comfortable in the presence of monarchs and premiers — indeed, he was often mistaken for the Duke of Windsor — he was contemptuous of pretension in every form. Perhaps more than anything else, this was the essence and irresistible appeal of Bob Magowan: a very special man who saw nothing very special about himself.*

*The fine qualities he demonstrated in the exercise of his leadership responsibilities have had a profound influence on the nature and direction of this company, and of the entire food industry. While missed, he is not forgotten. His enduring legacy at Safeway is an unending pursuit of excellence, tempered by a deep and abiding concern for people.*

Saleway Stores, Incorporated
Oakland, CA 94660

Bulk Rate
U.S. Postage
PAID
Permit No. 15431
Los Angeles, CA

YOUNG, JAMES E
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ARLINGTON TX 76013

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